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SIPDIS

SENSITIVE

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TREASURY FOR OASIA - JLEICHTER AND MMILLS
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TAGS: ECON EFIN TU
SUBJECT: THE LIRA'S OCTOBER DECLINE

REF: A. ANKARA 6554
¶B. ANKARA 6623

¶1. (Sbu) Summary: After a long rally, Turkish markets have turned down over the past two weeks, although there has been little in the way of high-profile, market-jolting bad news. Instead, the markets, especially the foreign exchange market, have turned around due to a combination of seasonal factors, foreign investors' profit-taking, and privatization process nervousness among other reasons. End Summary.

Lira Stops Appreciating, then Falls:

¶2. (Sbu) Turkish markets sustained summer and early fall rally started to fizzle in early October: the lira had already begun to weaken from its September 23 peak of TL 1.354 million per USD to TL 1.408 million on October 15. Strangely enough, the pressure on the lira accelerated after the GOT reached an agreement with Fund staff October 15 and submitted its budget to parliament October 17--events that should have cheered the markets.

¶3. (Sbu) The week of October 20 opened with what should have been the positive news of Finance Minister Unakitan's press conference on the just-submitted, fiscally-austere budget. Yet on October 20, the Central Bank, faced with sharply lower demand for TL, lowered its daily foreign exchange purchase auction amount from USD 120 million to USD 60 million as of October 21, and completely abandoned the FX purchases as of October 23. Nevertheless, the lira continued to fall, closing the week on October 24 at TL 1.486 million and diving Monday and during the half-day Tuesday, October 28 to TL 1.520 million, a five-month low. After the October 29 holiday, the lira came back on Thursday, October 30 to TL 1,498 million, however, Central Bank officials told econoff they did not expect a resumption of the lira rally.

¶4. (Sbu) The late summer nominal appreciation of the lira against the dollar had exaggerated the lira's overall appreciation: on a trade-weighted basis the lira's movement was less pronounced because the dollar fell against the euro during this period. By contrast, the late October fall in the lira/dollar rate was mirrored in the lira/euro rate and nothing to do with dollar/euro movements.

Why the Fall?

¶5. (Sbu) The fall in the lira is particularly interesting given that the markets had made it past a series of potentially-frightening political events without the feared outcomes materializing: the Dehap court case, the IMF mission visit, the signing of the U.S. Financial Agreement, and parliamentary authorization of a deployment to Iraq all turned out the way the markets wanted. Moreover, Standard and Poors announced it had moved the outlook for Turkey from negative to stable last week. So, why the fall now?

¶6. (Sbu) A confluence of factors seems to have reversed sentiment on the lira. First, the lira was probably overvalued. The currency had been appreciating in nominal terms since the spring despite an inflation rate far above that of Turkey's trading partners--in other words the lira's value had skyrocketed in real terms. Central Bank officials told econoffs they had been surprised at the height of the

lira's peak. Second, the lira often starts to weaken in the fall, as the summer tourism season with its FX inflows comes to an end. Market participants and central bank officials also say that there has been a significant movement by foreign players out of Turkish lira, reportedly to book their profits.

¶7. (Sbu) Several domestic developments appear to have unsettled market participants. First among these was a press report that the Government was drafting a new decree to "protect the Turkish lira," which would discourage domestic transactions denominated in foreign exchange. Though Economy Minister Babacan later denied that this represented a tightening of the foreign exchange control regime, markets were understandably negative on the idea. Also, early last week there were a several ministers made comments about Turkey not needing the USD 8.5 billion loan from the U.S., making markets nervous about the status of the assistance. On privatization, though the bids on parastatals Tupras and Tekel reportedly took place October 24, the Privatization Authority made the market nervous by saying it would not announce who bid until the week of November 1, adding to doubts about the real status of the bids, particularly on the oil refiner Tupras. Finally, worries about the status of the U.S. loan and yet another "reception crisis" between the President and the Ak Party Government over the wearing of headscarves at the Independence Day reception, further undermined market confidence.

¶8. (Sbu) In a meeting October 30, Central Bank officials explained to econoffs that the prospect of a repayment plan for Imar Bank depositors has also weighed on the foreign exchange market. According to these officials, the Central Bank succeeded in convincing the GOT to pay only TL 10 billion rather than TL 15 billion per depositor as a first instalment. Since half of the Imar Bank deposits had been in foreign exchange, the payment to depositors entirely in TL was likely to result in massive conversions back to foreign exchange, a prospect that weighed on the lira. The Central Bankers also told econoffs that there were market rumors of an impending Treasury debt swap that would be indexed to foreign exchange, leaving banks with open positions that the banks would have to close by selling lira. The Central Bankers' analysis about the Imar Bank would tend to be confirmed by the appreciation of the lira October 30, after the repayment plan--at the lesser amount--was announced. The passing of the headscarf "reception crisis" may also have helped market sentiment.

¶9. (Sbu) There is also beginning to be increased concern about balance of payments issues and the prospects for the Current Account deficit. In recent months, there has been little discussion about BOP concerns, in part due to the buoyancy of exports and the apparently positive trends in the overall economy. In a speech October 16, however, former Economy Minister Kemal Dervis warned about the Current Account deficit. On October 27, the Central Bank announced August BOP numbers, showing that the twelve-month rolling Current Account deficit rose to USD 4.3 billion at the end of August, and that the Current Account deficit for the year was projected to reach USD 7.7 billion, or about 3.1 percent of GDP. Some analysts are beginning to express concern about the Current Account deficit. On the other hand, an IMF official told econoff October 20 that the Fund did not have particular concerns about the outlook for the Current Account, given the GOT's access to financing and the floating exchange rate regime. Central Bank Markets Department officials articulated a similar view, expressing confidence that the floating exchange rate regime acts as an automatic stabilizer.

Milder Correction in Debt Market:

¶10. (Sbu) The sharpest movements were in the foreign exchange and equity markets, but the debt market was not immune. Though on October 17 the benchmark bond was still trading at 29.74 percent, near its post-crisis low, during the week of October 20-24 it rose to 31.58 and by the close October 28 it closed at 32.12 percent. In the October 30 post-holiday uptick, the benchmark closed at 31.70. It is noteworthy that the domestic debt market bore up better than the currency and equity markets, despite large redemptions the week of October 20-24. Central Bank officials agreed that this disconnect between the debt and FX markets demonstrated that foreigners moving out of lira instruments were a key factor in the fall of the lira, since the domestic debt market is less influenced by foreign investors.

Comment:

¶11. (Sbu) It is too soon to tell whether the fall in the lira represents a sustained change of direction, which could lead to concerns about overshooting and problems on the inflation and debt fronts. For now, it should at least have the positive effect of muting pressures on the Central Bank from politicians and business people to do something about the strong lira. Though the weaker lira could make it harder for Turkey to make its 2003 inflation target, Central Bank officials told econoffs there might not be too big an impact, at least in 2003. According to these officials business people have not been quick to pass through exchange rate fluctuations into their prices, reducing the correlation between exchange rate movements and inflation. If there is an effect, these officials expect it to hit with a lag, causing inflation in early 2004.

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